



API Testimony by Ed Murphy on Boutique Fuels Legislation before the House Energy and Commerce Committee June 7, 2006

My name is Edward Murphy. I am the Group Director for Downstream and Industry Operations at the American Petroleum Institute and am testifying on API's behalf. API is a national trade association representing more than 400 companies involved in all aspects of the U.S. oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry.

API welcomes the opportunity to comment on the boutique fuels issue. "Boutique" fuels are specialized fuel formulations unique to a particular market, imposed by federal, state or local laws, and that cannot be obtained from other markets in the same regional distribution system.

Most of the existing boutique fuels were meant to address local or regional air quality issues. They were well-intentioned – but have occasionally led to serious unintended consequences. State and local bio-fuel mandates are rapidly adding to the number. Boutiques can contribute to tight supplies and price volatility, particularly in the event of a supply disruption or stress.

Nothing is more important in our business than the reliability of supply, and a rigid system of state-specific boutique fuels can reduce that reliability at times when supplies are already short. This legislation recognizes the importance of maintaining flexibility in our fuel manufacturing and distribution systems

It is important to note, however, that the patchwork of localized boutique fuels is not principally responsible for the recent higher gasoline prices, and enactment and implementation of this legislation would not address the most important drivers of the gasoline price increases we have experienced over the past several months. The rising cost of crude oil has been the dominant factor. At \$70 a barrel, crude oil costs account for \$1.67 of the price of a gallon of gasoline. Crude costs plus taxes – an average of 46 cents per gallon – account for about three-fourths of pump prices. The boutique fuel problem manifests itself most often as geographically and temporally localized shortage, not always accompanied by price increases.

Nevertheless, the proliferation of boutique fuels, which resulted from the Clean Air Act Amendments of 1990, in recent years has presented significant challenges to U.S. refiners and resulted in a fuel system too encumbered to quickly respond to unavoidable events. That has contributed to fuel unavailability and/or price volatility that has hurt consumers.

It is important to understand that limiting the number of boutique fuels is not a silver bullet as new areas consider fuels programs. EPA should still require a demonstration of need by the state. There also needs to be sufficient lead time to ensure that companies are all able to produce the new fuel. Moreover, supply considerations must be taken into account as a more stringent formulation will result in a reduction in fuel producibility.

Fuel providers need the flexibility to get fuel to where it is most needed and to quickly adjust to changes in demand. Additionally, marketers need some assurance that, if they are unable to secure the type of fuel they need at a particular supplier or terminal, they will be able to go elsewhere for product. However, a rigid system of state-specific boutique fuels reduces the reliability of supply and increases the risk of spot shortages and price volatility.

The Energy Policy Act of 2005 (EPACT05) included a provision setting some restrictions on EPA for approval of states' fuels intended for reducing air pollution. In addition, Congress required that EPA and the DOE complete two studies regarding boutique fuels (one this year and one in 2008). We look forward to the results of this study and its recommendation regarding how the number of boutique fuels may be reduced while balancing environmental needs and supply capability. In particular, we need such a careful study to weigh the impact of increased fuel fungibility from a reduced number of fuels with the reduction in production capability that will occur if the overall fuel specifications are made more stringent in the process of insuring continued environmental performance.

Policy-makers clearly recognized the harmful effects of widespread adoption of boutique fuels. But more needs to be done and we commend the Chairman for his willingness to address the problem.

The legislation before this committee builds on measures addressing boutique fuels included in last year's EPACT05. This legislation contains positive provisions that deal with the air-quality boutiques, however, the bigger challenge now facing us is the recent proliferation of bio-fuel boutiques that are just as disruptive to supply but lack a basis in improving air quality. We feel strongly that the addition of provisions restricting state bio-fuel mandates would substantially strengthen what has been proposed. More state bio-fuel mandates could undo or offset much of the benefit your legislation as well as EPACT05 promises to provide.

Provisions in the legislation before us today could help further limit the spread of boutique fuels by:

- Grandfathering and walling off the Texas low emission diesel program and the Phoenix, Arizona and Clark County, Nevada Clean Burning Gasoline programs, preventing adoption in other states.

- Including, as an interim step, a PADD specific cap with a ratchet-down feature that would reduce the number of available fuels that may be required once air quality improvements are attained.
- Disallowing the inclusion in the state fuels slate of controls for sulfur and toxics parameters beyond federally required levels, and
- Limiting growth in state highway diesel programs to avoid a parallel boutique problem for diesel fuel.

We think it is important that EPA carefully evaluate the impact of a reduced slate of fuels, in order to prevent a reduction in supply capability resulting from a tightening of fuel specifications without corresponding environmental benefits. Most importantly, this legislation does nothing to limit state-mandated bio-fuel programs.

This is a serious omission. If the issue is fuel fungibility and distribution, boutique fuels include all gasolines and diesel fuels mandated at any government level. Whether the fuel requirement is imposed at the federal, state, or local level, for environmental or other reasons, if the result is a different fuel – conventional or bio-fuel – it adversely impacts the system fungibility and raises the potential for market volatility.

Moreover, bio-fuels mandates are increasing in number.

It was anticipated that the passage of a federal Renewable Fuels Standard (RFS) program, mandating 7.5 billion gallons of renewables by 2012, would eliminate the need for additional state mandates. However, just the opposite has occurred. Despite the federal RFS program several states have either implemented or passed varying forms of biofuel mandates in 2006. Of those, Hawaii's mandate took effect, Washington passed legislation and lawmakers in Missouri and Louisiana have passed bills which are now with their governors for final consideration. Iowa enacted legislation that will have the effect of a mandate, and Colorado's Governor vetoed a mandate bill passed by that legislature earlier this year. Moreover, several other state legislatures have passed a mandate in at least one house and many others have actively considered such legislation. Minnesota already had a mandate in effect, and Montana has passed mandate legislation but it won't be implemented until the state reaches a certain production threshold.

Bio-fuels can contribute to our motor fuel pool and will continue to expand their market share to the extent they meet consumers' needs. Equally important, the federal RFS will ensure continued growth in renewables, especially ethanol.

Unlike potential state mandates, the RFS builds in flexibility. Its credit banking and trading component, when established through regulations by EPA, should allow refiners to use renewables where they are most efficient. This is critical for the reliable supply of fuels.

State mandates undermine that flexibility and create obstacles to the achievement of Congress' goals. Individual states should not be permitted to force the use of ethanol or biodiesel by devising and mandating their own gasoline/ethanol and/or diesel/biodiesel blends. The last thing our nation needs now is an expansion of the boutique fuels patchwork of state-by-state laws mandating ethanol and/or biodiesel use at different concentrations and/or under different terms.

Here are examples of the kind of problems that state bio-fuels mandates could create:

- A per gallon mandate requires that E10 be available at all times. Thus, a shortage of ethanol for any reason means that gasoline could not be sold.
- If the governor has chosen to eliminate the 1 pound waiver or if the state has a low rvp fuel requirement, refiners may need to produce a low RVP blendstock (BOB) for conventional gasoline.
- For areas requiring RFG, refiners would be required to produce a lower RVP blend of RFG, i.e. a reformulated BOB, for blending with ethanol. While most are choosing to do this now, it is possible that in the future some will choose to produce RFG with no oxygenates. This would not be possible in a mandate state.

Integrating ethanol and other biofuels into the gasoline marketplace is too important – and presents too many challenges – to be approached in an individual, state-by-state manner. In order to meet consumer fuel needs, we want to produce more, refine more, and distribute more – but state bio-fuel mandates would make this difficult. For example, ethanol cannot be moved by common carrier pipeline, unlike more than 70 percent of U.S. fuel production, and requires a long supply chain to serve consumers. That means a longer reaction time when problems occur. State ethanol mandates would significantly add to that reaction time. We oppose this patchwork approach, whose adverse impacts are felt most by individual gasoline consumers. This is particularly important as we continue to see record ethanol futures prices. (The Chicago Board of Trade's June 2006 contract set a record on June 2, 2006 of \$3.68 per gallon. This is equivalent to \$154.56 per barrel.)

This legislation contains provisions that are positive. But we urge consideration of extending restrictions on state-mandated fuels to include renewables or bio-fuels. Given the existence of the federal RFS mandating the use of a minimum volume of biofuels each year, and a trading program intended to provide flexibility in where the biofuels are used, all state biofuel mandates should be federally

preempted. Moreover, existing state biofuel mandates should become subject to review by EPA and DOE to determine whether they are likely to adversely impact the supply of fuel to the mandated area, or surrounding areas.

Also, the legislation should be strengthened to further limit diesel boutiques (except for the existing Texas program) by preempting all state diesel programs, including those that address non-road fuels.

At a minimum, we strongly recommend that this legislation amend EPACT05 to require study of the supply and distribution impacts of state bio-fuels mandates. Also, EPA should be required to review potential supply impacts of any fuel under consideration for approval. Simply reducing the number of fuels is not sufficient especially if it means moving to more stringent formulations that reduce producibility which, in turn, could also have adverse supply impacts.